

ORIGINAL

MARC J. FAGEL (Cal. Bar No. 154425)
CARY S. ROBNETT (Cal. Bar No. 160585)
TRACY L. DAVIS (Cal. Bar No. 184129)
DavisTL@sec.gov
STEVEN D. BUCHHOLZ (Cal. Bar No. 202638)
BuchholzS@sec.gov

Attorneys for Plaintiff
SECURITIES AND EXCHANGE COMMISSION
44 Montgomery Street, Suite 2600
San Francisco, California 94104
Telephone: 415-705-2500
Facsimile: 415-705-2501

E-filing

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA
SAN FRANCISCO DIVISION

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

vs.

HONG LIANG LU and MICHAEL J. SOPHIE,

Defendants.

CV 08 Case No.

2262

COMPLAINT

PJH

Plaintiff Securities and Exchange Commission (the "Commission") alleges against defendants Hong Liang Lu ("Lu") and Michael J. Sophie ("Sophie") ("Defendants"):

SUMMARY OF THE ACTION

1. Lu, the Chief Executive Officer of UTStarcom, Inc. ("UTSI" or "the company"), and Sophie, UTSI's former Chief Financial Officer, certified, pursuant to Section 302 of the Sarbanes-Oxley Act, the accuracy and completeness of UTSI's quarterly and annual reports filed with the SEC. UTSI's reports were not accurate and complete, however. Between 2000 and 2006, telecommunications company UTSI improperly recognized revenue on transactions subject to undisclosed side agreements, failed to properly disclose and account for related party transactions, and failed to properly record compensation expenses related to employee stock

1 options. Despite being put on notice of potential accounting issues by, among other things,
2 material weakness letters sent by the company's outside auditor, Defendants falsely certified that
3 UTSI's quarterly and annual reports did not contain any material misstatements or omissions,
4 disclosed all significant deficiencies in UTSI's internal controls, and fairly presented UTSI's
5 financial condition and results of operations.

6 2. In a separate administrative proceeding relating to these violations, the
7 Commission has issued an order directing Lu and Sophie to cease and desist from committing or
8 causing any violations or future violations of certain provisions of the federal securities laws.

9 3. In this action, the Commission seeks a Court order requiring Defendants to pay
10 civil monetary penalties for violating Rule 13a-14 of the Securities Exchange Act of 1934
11 ("Exchange Act") based on the same facts and circumstances.

12 JURISDICTION AND VENUE

13 4. The Commission brings this action pursuant to Section 21(d)(3) of the Exchange
14 Act [15 U.S.C. § 78u(d)(3)].

15 5. This Court has jurisdiction over this action pursuant to Sections 21(d)(3) and 27
16 of the Exchange Act [15 U.S.C. §§ 78u(d)(3) and 78aa].

17 6. Venue in this District is proper pursuant to Section 27 of the Exchange Act [15
18 U.S.C. § 78aa] because Defendants reside and transact business within the Northern District of
19 California.

20 7. Intradistrict assignment to the San Francisco Division is proper pursuant to Civil
21 L.R. 3-2(c) because a substantial part of the events or omissions that give rise to this action
22 occurred in the County of Alameda.

23 DEFENDANTS

24 8. Hong Liang Lu, 53, is a co-founder of UTSI and has served as a board member
25 and Chief Executive Officer since 1995. Lu resides in San Ramon, California and Hangzhou,
26 China.
27
28

1 agreements, or side letters, to supplement or amend contractual terms. Such letters were allowed
2 so long as the accounting for them was done properly.

3 13. UTSI received another Management Recommendation letter from its auditor in
4 April 2004 detailing multiple internal control weaknesses (many classified as material) identified
5 during the December 31, 2003 year-end audit. The letter was copied to Lu and Sophie, and again
6 noted concerns about the use of side letters that were not forwarded to the finance department.
7 The auditor also expressed concerns with many complex related-party transactions entered into
8 by UTSI. The auditor informed UTSI that the company did not adequately disclose significant
9 transactions involving joint venture arrangements between UTSI and its customers. In its written
10 response, UTSI said it had strengthened controls to identify side letters and implemented
11 monitoring procedures to identify significant joint venture transactions.

12 **A. UTSI Prematurely Recognized Revenue From International Sales Subject To**
13 **Undisclosed Side Agreements**

14 14. Between 2003 and 2005, UTSI prematurely recognized nearly \$50 million in net
15 revenue from international sales, all of which occurred outside the U.S., which were subject to
16 side agreements that had been concealed from the company's finance personnel. Because these
17 agreements promised future performance by UTSI, revenue should not have been recognized
18 under Generally Accepted Accounting Principles ("GAAP").

19 15. Among other contingent transactions, UTSI improperly recognized revenue from
20 the sale of a \$22 million network system to a purchaser in India. At the time of the sale,
21 securities analysts had expressed concerns about UTSI's ability to enter markets outside China,
22 and Lu specifically highlighted this deal as indicative of UTSI's success in gaining traction in
23 India.

24 16. UTSI delivered the system and recognized revenue from the \$22 million sale in
25 phases over several quarters, including the second quarter of 2004 and the second quarter of
26 2005. Before recognizing the revenue, UTSI's finance department required the purchaser to sign
27 a final acceptance certificate certifying that all elements of the phase had been delivered and
28 successfully installed.

1 17. During the second quarter of 2004, the purchaser sent UTSI the final acceptance
2 certificate, but included a proposed side agreement requiring UTSI to upgrade the system after
3 the end of the quarter. Lu and Sophie were aware of the proposed side agreement. UTSI's
4 revenue recognition manager, with the knowledge of Lu and Sophie, specifically admonished
5 that approving the side agreement would prevent revenue recognition. Lu personally
6 communicated with the customer to request that they accept the products without a side
7 agreement.

8 18. Notwithstanding the admonition, a UTSI sales executive signed a side agreement
9 with the purchaser, but failed to adequately disclose the agreement to finance personnel,
10 resulting in the improper recognition of revenue by the company. Lu and Sophie failed to take
11 adequate steps to determine how the customer's request for a side agreement had been resolved
12 and whether revenue recognition was appropriate.

13 19. During the second quarter of 2005, UTSI recognized additional revenue from the
14 India sale. Once again, a UTSI sales executive had signed a side letter making the customer's
15 acceptance contingent on future upgrades (and thus rendering revenue recognition improper
16 under GAAP). Lu and Sophie were aware the customer had made such a request, but received a
17 communication from finance personnel that the final acceptance certificates received from the
18 customer were acceptable. Neither Lu nor Sophie took steps to determine how the issue was
19 resolved and whether revenue was properly recognized.

20 20. In addition to the India transaction, UTSI entered into five other international
21 sales transactions totaling \$27.5 million in net revenue where side agreements had been entered
22 into promising future products or services. These side agreements should have precluded
23 revenue recognition. On June 26, 2006, UTSI restated its financial statements for the period
24 between Q1 2003 through Q3 2005, reversing \$49.5 million in net revenue that had been
25 improperly recognized by the company.

B. UTSI Prematurely Recognized Revenue On Sales In China With Undisclosed Contract Modifications

21. Between 2000 and 2005, UTSI prematurely recognized over \$350 million in revenue from 78 sales transactions in China. On some occasions, UTSI sales personnel entered into contracts that contained non-standard product upgrade provisions precluding revenue recognition. In some instances, sales personnel documented the sales on two separate contracts, and only the company's standard contract (without the upgrade provisions) was made available to UTSI's finance personnel. As a result, UTSI repeatedly recognized revenue for contingent sales in violation of GAAP.

22. Lu and Sophie had been on notice since at least 2003 of significant internal control weaknesses in China, including the fact that in some instances side letters and contract amendments introducing revenue contingencies were not forwarded by sales offices to the contract and finance departments. Although Lu and Sophie took steps to improve internal controls in response to this information, neither those steps nor the resulting controls were sufficient to detect the improper dual contract practices and failed to prevent certain improprieties.

23. On October 10, 2007, UTSI restated its financial statements from 2000 through the second quarter of 2006 to reverse \$271 million in net revenue improperly recognized by the company.

C. UTSI Failed to Disclose and Properly Account for Related Party Transactions

24. In 2001, a China-based company called MDC was formed in order to provide value-added services to UTSI products. The father of UT-China's Executive Vice President founded MDC; the UT-China executive served as the "alternate" chairman of MDC's board of directors. Numerous officers and other employees of UT-China invested in MDC, and certain UT-China employees worked for MDC while their salaries were paid by UT-China.

25. In 2003, UT-China entered into a complex transaction involving MDC and another customer in China, whereby MDC took ownership of UTSI inventory that had decreased

1 in value. Because UTSI failed properly to treat MDC as a consolidated entity, no impairment of
2 the inventory value was recorded by UTSI at the time.

3 26. Lu and Sophie had been on notice of concerns raised by the company's auditor
4 about UTSI's failure to adequately disclose related party transactions entered into by UTSI.
5 Although Lu and Sophie took steps to improve internal controls in response to this information,
6 neither those steps nor the resulting controls were sufficient to detect the improper transaction
7 with MDC and failed to prevent inaccurate reporting of certain related party transactions.

8 27. On April 13, 2005, UTSI restated its 2003 financial statements in part to
9 consolidate MDC, as MDC was deemed a related party controlled by UTSI. The restatement
10 resulted in the write down of \$7.5 million in UTSI inventory held by MDC.

11 **D. UTSI Failed Properly to Account for Stock Compensation Expenses**

12 28. UTSI failed properly to account for certain stock option grants because the
13 company used incorrect grant dates for determining compensation expenses. Under GAAP,
14 UTSI was required to record an expense on its financial statements for any stock options granted
15 "in-the-money" – i.e. where the exercise price of the option was less than the market price for the
16 security on the date the option was granted.

17 29. Certain grants to UTSI officers were backdated or accounted for with incorrect
18 grant dates prior to the proper authorization of the grant by the company's Compensation
19 Committee. This resulted in an exercise price below market price on the date of the grant, yet no
20 expense was recorded by the company.

21 30. UTSI failed to establish and implement adequate internal controls for the granting
22 of employee stock options. Among other things, UTSI failed to maintain necessary
23 documentation showing when the grants were actually authorized by the Compensation
24 Committee.

25 31. On October 10, 2007, UTSI restated its financial statements from 1998 through
26 the second quarter of 2006 to recognize an additional \$27 million in compensation expenses
27 related to employee stock options.
28

E. Defendants Signed False Certifications Under Section 302 of the Sarbanes-Oxley Act

32. Lu and Sophie, as UTSI's CEO and CFO, were required to sign certifications each fiscal quarter and fiscal year stating that, based on their knowledge, the company's quarterly and annual reports did not contain any misstatements or omit material information, that the reports disclosed all significant deficiencies in the design or operation of UTSI's internal controls, and that the reports fairly presented in all material respects UTSI's financial condition and results of operations. Lu executed such certifications for the quarters and years from the first quarter of 2004 through the second quarter of 2006, and Sophie executed such certifications for the quarters and years from the first quarter of 2004 through the second quarter of 2005. For the reasons set forth above, these certifications were false.

CLAIM FOR RELIEF

Violations of Rule 13a-14 of the Exchange Act [17 C.F.R. § 240.13a-14]

33. Paragraphs 1 through 21 are re-alleged and incorporated herein by reference.

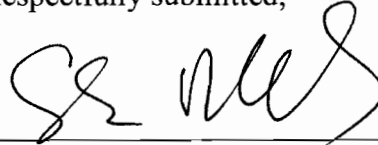
34. Rule 13a-14 of the Exchange Act [17 C.F.R. § 240.13a-14] requires quarterly and annual reports on Forms 10-Q and 10-K to include certifications of the issuer's principal executive and principal financial officers in the form set forth under Section 302 of the Sarbanes-Oxley Act [15 U.S.C. § 7241].

35. By falsely certifying that UTSI's quarterly and annual reports did not contain any material misstatements or omissions, disclosed all significant deficiencies in UTSI's internal controls, and fairly presented UTSI's financial condition and results of operations, Defendants violated Rule 13a-14 of the Exchange Act [17 C.F.R. § 240.13a-14].

PRAYER FOR RELIEF

WHEREFORE, the Commission respectfully requests that the Court enter a Final Judgment ordering Defendants to pay civil monetary penalties pursuant to Section 21(d)(3) of the Exchange Act [15 U.S.C. § 78u(d)(3)] and granting such other relief as the Court deems appropriate.

Respectfully submitted,



Dated: May 1, 2008

Marc J. Fagel
Cary S. Robnett
Tracy L. Davis
Steven D. Buchholz
Attorneys for Plaintiff
SECURITIES AND EXCHANGE COMMISSION

E-filing

CIVIL COVER SHEET

ORIGINAL

JS 44 (Rev. 12/07) (and rev 1-16-08)

The JS 44 civil cover sheet and the information contained herein neither replace nor supplement the filing and service of pleadings or other papers as required by law, except as provided by local rules of court. This form, approved by the Judicial Conference of the United States in September 1974, is required for the use of the Clerk of Court for the purpose of initiating the civil docket sheet. (SEE INSTRUCTIONS ON PAGE TWO OF THE FORM.)

I. (a) PLAINTIFFS

Securities and Exchange Commission

DEFENDANTS

Hong Liang Lu and Michael J. Sophie

(b) County of Residence of First Listed Plaintiff San Francisco
(EXCEPT IN U.S. PLAINTIFF CASES)

County of Residence of First Listed Defendant Contra Costa County
(IN U.S. PLAINTIFF CASES ONLY)

NOTE: IN LAND CONDEMNATION CASES, USE THE LOCATION OF THE LAND INVOLVED.

(c) Attorney's (Firm Name, Address, and Telephone Number)

Securities and Exchange Commission
44 Montgomery Street, Suite 2600
San Francisco, CA 94104
(415) 705-2500

Attorneys (If Known)

Boris Feldman, Esq.
Wilson Sonsini Goodrich & Rosati P.C.
650 Page Mill Road
Palo Alto, CA 94304

II. BASIS OF JURISDICTION (Place an "X" in One Box Only)

- ☒ 1 U.S. Government Plaintiff ☐ 3 Federal Question (U.S. Government Not a Party)
- ☐ 2 U.S. Government Defendant ☐ 4 Diversity (Indicate Citizenship of Parties in Item III)

III. CITIZENSHIP OF PRINCIPAL PARTIES (Place an "X" in One Box for Plaintiff and One Box for Defendant)

- | | PTF | DEF | | PTF | DEF |
|---|----------------------------|----------------------------|---|----------------------------|----------------------------|
| Citizen of This State | <input type="checkbox"/> 1 | <input type="checkbox"/> 1 | Incorporated or Principal Place of Business In This State | <input type="checkbox"/> 4 | <input type="checkbox"/> 4 |
| Citizen of Another State | <input type="checkbox"/> 2 | <input type="checkbox"/> 2 | Incorporated and Principal Place of Business In Another State | <input type="checkbox"/> 5 | <input type="checkbox"/> 5 |
| Citizen or Subject of a Foreign Country | <input type="checkbox"/> 3 | <input type="checkbox"/> 3 | Foreign Nation | <input type="checkbox"/> 6 | <input type="checkbox"/> 6 |

IV. NATURE OF SUIT (Place an "X" in One Box Only)

CONTRACT	TORTS	FORFEITURE/PENALTY	BANKRUPTCY	OTHER STATUTES	
<input type="checkbox"/> 110 Insurance <input type="checkbox"/> 120 Marine <input type="checkbox"/> 130 Miller Act <input type="checkbox"/> 140 Negotiable Instrument <input type="checkbox"/> 150 Recovery of Overpayment & Enforcement of Judgment <input type="checkbox"/> 151 Medicare Act <input type="checkbox"/> 152 Recovery of Defaulted Student Loans (Excl. Veterans) <input type="checkbox"/> 153 Recovery of Overpayment of Veteran's Benefits <input type="checkbox"/> 160 Stockholders' Suits <input type="checkbox"/> 190 Other Contract <input type="checkbox"/> 195 Contract Product Liability <input type="checkbox"/> 196 Franchise	PERSONAL INJURY <input type="checkbox"/> 310 Airplane <input type="checkbox"/> 315 Airplane Product Liability <input type="checkbox"/> 320 Assault, Libel & Slander <input type="checkbox"/> 330 Federal Employers' Liability <input type="checkbox"/> 340 Marine <input type="checkbox"/> 345 Marine Product Liability <input type="checkbox"/> 350 Motor Vehicle <input type="checkbox"/> 355 Motor Vehicle Product Liability <input type="checkbox"/> 360 Other Personal Injury	<input type="checkbox"/> 362 Personal Injury—Med. Malpractice <input type="checkbox"/> 365 Personal Injury—Product Liability <input type="checkbox"/> 368 Asbestos Personal Injury Product Liability PERSONAL PROPERTY <input type="checkbox"/> 370 Other Fraud <input type="checkbox"/> 371 Truth in Lending <input type="checkbox"/> 380 Other Personal Property Damage <input type="checkbox"/> 385 Property Damage Product Liability	<input type="checkbox"/> 610 Agriculture <input type="checkbox"/> 620 Other Food & Drug <input type="checkbox"/> 625 Drug Related Seizure of Property 21 USC 881 <input type="checkbox"/> 630 Liquor Laws <input type="checkbox"/> 640 R.R. & Truck <input type="checkbox"/> 650 Airline Regs. <input type="checkbox"/> 660 Occupational Safety/Health <input type="checkbox"/> 690 Other LABOR <input type="checkbox"/> 710 Fair Labor Standards Act <input type="checkbox"/> 720 Labor/Mgmt. Relations <input type="checkbox"/> 730 Labor/Mgmt. Reporting & Disclosure Act <input type="checkbox"/> 740 Railway Labor Act <input type="checkbox"/> 790 Other Labor Litigation <input type="checkbox"/> 791 Empl. Ret. Inc. Security Act IMMIGRATION <input type="checkbox"/> 462 Naturalization Application <input type="checkbox"/> 463 Habeas Corpus—Alien Detainee <input type="checkbox"/> 465 Other Immigration Actions	<input type="checkbox"/> 422 Appeal 28 USC 158 <input type="checkbox"/> 423 Withdrawal 28 USC 157 PROPERTY RIGHTS <input type="checkbox"/> 820 Copyrights <input type="checkbox"/> 830 Patent <input type="checkbox"/> 840 Trademark SOCIAL SECURITY <input type="checkbox"/> 861 HIA (1395ff) <input type="checkbox"/> 862 Black Lung (923) <input type="checkbox"/> 863 DIWC/DIWW (405(g)) <input type="checkbox"/> 864 SSID Title XVI <input type="checkbox"/> 865 RSI (405(g)) FEDERAL TAX SUITS <input type="checkbox"/> 870 Taxes (U.S. Plaintiff or Defendant) <input type="checkbox"/> 871 IRS—Third Party 26 USC 7609	<input type="checkbox"/> 400 State Reapportionment <input type="checkbox"/> 410 Antitrust <input type="checkbox"/> 430 Banks and Banking <input type="checkbox"/> 450 Commerce <input type="checkbox"/> 460 Deportation <input type="checkbox"/> 470 Racketeer Influenced and Corrupt Organizations <input type="checkbox"/> 480 Consumer Credit <input type="checkbox"/> 490 Cable/Sat TV <input type="checkbox"/> 810 Selective Service <input checked="" type="checkbox"/> 850 Securities/Commodities/Exchange <input type="checkbox"/> 875 Customer Challenge 12 USC 3410 <input type="checkbox"/> 890 Other Statutory Actions <input type="checkbox"/> 891 Agricultural Acts <input type="checkbox"/> 892 Economic Stabilization Act <input type="checkbox"/> 893 Environmental Matters <input type="checkbox"/> 894 Energy Allocation Act <input type="checkbox"/> 895 Freedom of Information Act <input type="checkbox"/> 900 Appeal of Fee Determination Under Equal Access to Justice <input type="checkbox"/> 950 Constitutionality of State Statutes
REAL PROPERTY <input type="checkbox"/> 210 Land Condemnation <input type="checkbox"/> 220 Foreclosure <input type="checkbox"/> 230 Rent Lease & Ejectment <input type="checkbox"/> 240 Torts to Land <input type="checkbox"/> 245 Tort Product Liability <input type="checkbox"/> 290 All Other Real Property	CIVIL RIGHTS <input type="checkbox"/> 441 Voting <input type="checkbox"/> 442 Employment <input type="checkbox"/> 443 Housing/Accommodations <input type="checkbox"/> 444 Welfare <input type="checkbox"/> 445 Amer. w/Disabilities—Employment <input type="checkbox"/> 446 Amer. w/Disabilities—Other <input type="checkbox"/> 440 Other Civil Rights	PRISONER PETITIONS <input type="checkbox"/> 510 Motions to Vacate Sentence Habeas Corpus: <input type="checkbox"/> 530 General <input type="checkbox"/> 535 Death Penalty <input type="checkbox"/> 540 Mandamus & Other <input type="checkbox"/> 550 Civil Rights <input type="checkbox"/> 555 Prison Condition			

V. ORIGIN (Place an "X" in One Box Only)

- ☒ 1 Original Proceeding ☐ 2 Removed from State Court ☐ 3 Remanded from Appellate Court ☐ 4 Reinstated or Reopened ☐ 5 Transferred from another district (specify) ☐ 6 Multidistrict Litigation ☐ 7 Appeal to District Judge from Magistrate Judgment

VI. CAUSE OF ACTION

Cite the U.S. Civil Statute under which you are filing (Do not cite jurisdictional statutes unless diversity):

[17 C.F.R. § 240.13a-14] and [15 U.S.C. § 7241]

Brief description of cause:

False officer certifications in public financial filings.

VII. REQUESTED IN COMPLAINT:

☐ CHECK IF THIS IS A CLASS ACTION UNDER F.R.C.P. 23 **DEMAND \$**

CHECK YES only if demanded in complaint:

JURY DEMAND: ☐ Yes ☒ No

VIII. RELATED CASE(S) IF ANY

PLEASE REFER TO CIVIL L.R. 3-12 CONCERNING REQUIREMENT TO FILE "NOTICE OF RELATED CASE".

IX. DIVISIONAL ASSIGNMENT (CIVIL L.R. 3-2) (PLACE AND "X" IN ONE BOX ONLY)

☒ SAN FRANCISCO/OAKLAND

☐ SAN JOSE

DATE

5/1/08

SIGNATURE OF ATTORNEY OF RECORD

SE [Signature]